

May 31, 2012  
Initiating Coverage

**RATING: Buy**  
**Price Target: \$40.00**

## Facebook (FB - \$28.19)

We "Like" The Optionality; Initiating With a Buy

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STOCK DATA	
Price	\$28.19
Price Target	\$40.00
Market Cap (\$M)	\$77,877
52-Week Range	\$28.19 - \$45.00
Shares (mil)	2,762.6
ADTV (000)	70,000
Enterprise Value (\$M)	\$67,606
Dividend Per Share	NA
Yield	NA

FINANCIAL DATA			
LT EPS CAGR	28.1%		
	2011A	2012E	2013E
EV/Revenue	18	13	10
P/E Ratio	65.6x	65.6x	42.7x
EV/EBITDA	29.4x	24.2x	18.0x

REVENUE (\$M)			
FY December	2011A	2012E	2013E
Q1	731.0	1,058.0A	1,368.7E
Q2	895.0	1,222.4E	1,590.6E
Q3	954.0	1,304.7E	1,714.2E
Q4	1,131.0	1,495.8E	1,942.0E
FY	3,711.0	5,080.8E	6,615.5E

EPS			
FY December	2011A	2012E	2013E
Q1	0.00	0.10A	0.14E
Q2	0.00	0.10E	0.16E
Q3	0.00	0.10E	0.16E
Q4	0.00	0.13E	0.20E
FY	0.43	0.43E	0.66E

EPS: Adjusted EPS

### Summary

We are initiating coverage of Facebook with a Buy rating and a \$40 price target, based on the Company's current revenue and profit streams. However, we believe Facebook is in the early innings of its monetization potential, and upside to our price target lies in the answers to the following four key questions: 1) How much incremental money can Facebook make from their 900M-plus user base and the content those users provide? 2) How and when will those monetization opportunities be available to advertisers and users? 3) How much of it will advertisers and users buy? 4) What is the value of these options? We believe that Facebook will continue to gain share of advertising budgets and could use their platform to capitalize on lateral opportunities to build shareholder value.

### Key Points

- **Less Than 1% Penetrated of a \$1 Trillion Addressable Market.** Facebook is levered to a large addressable market that goes beyond its core market today of online display advertising and virtual goods, extending to online search, e-commerce, mobile, online classifieds, online payments, and online video advertising. Together, those markets represent a \$1 trillion addressable market for Facebook to exploit. We see Facebook's share of global online display advertising rising from 3.6% in 2011 to 6.5% in 2016, as advertiser adoption of social networking platforms continue to grow.
- **Online Search and E-Commerce Could Represent \$9 of Incremental Value.** In our view, Facebook will need to pursue opportunities that are readily monetizable such as online search and e-commerce. Our work points to \$9 per share of incremental value (\$7 for search; \$2 for e-commerce) if Facebook were to pursue those opportunities. In online search, Facebook would have a cost advantage over Google because the URLs are supplied by users. We believe that approximately 20% of Facebook employees are Google alumni, thus the ability to offer an online search offering lies in-house. E-Commerce is a natural extension and the elements are in place for Facebook to allow stores to develop a presence and sell goods.
- **Monetize Mobile Through Partnerships With Telcos.** Facebook's best chance at significant monetization of mobile is through partnerships with the telecommunication companies. The key here is for Facebook to forge strategic alliances with the Telcos, have social functions built into the phones, and receive a revenue share of the monthly user payments. That would negate the need to build their own OS and a Facebook phone.
- **Addressing The Concerns.** In this report, we address investor concerns including the 1Q12 QoQ revenue decline, dependence on Zynga (ZNGA: \$5.87: NR), the patent wars, the Instagram purchase, and how advertisers view the platform.

### Valuation

Facebook is currently valued at 24x 2012E EV/EBITDA. Our \$40 price target for year-end 2013 is based on a 20x multiple to our 2014E Adjusted EBITDA estimate, a reasonable multiple considering our 29% long-term Adjusted EBITDA growth estimate. We support our multiple-based valuation with a DCF with a WACC of 11% and 7.6x implied terminal multiple on EBITDA.

## Company Profile

Facebook is the largest online social network in the world, with 901 million monthly active users as of March 31, 2012. Over half of those users are active on a daily basis and over half access Facebook through mobile platforms. The user base is spread across the globe, except for China, Iran, Syria, and North Korea, where the service is blocked, with the U.S. accounting for 21% of total active users; Europe at 27%; Asia at 25%; and ROW at 27%. Facebook generates 82% of revenues through online advertising and 18% of revenues through payments. Online advertising is primarily display advertising. Payments revenues are derived from platform developers, primarily gaming companies such as Zynga that pay a fee when their users make purchases on Facebook's platform. Facebook was founded in 2004 by Mark Zuckerberg in his Harvard University dorm room. The Company went public on May 18, 2012 at \$38 per-share.

## Investment Thesis

We are initiating coverage of Facebook with a Buy rating and a \$40 price target for year-end 2013, based on the Company's current revenue and profit streams. However, we believe Facebook is in the early innings of its monetization potential, and upside to our price target lies in the answers to the following four key questions:

- 1) How much incremental money can Facebook make from their 900M-plus user base and the content those users provide?
- 2) How and when will those monetization opportunities be available to advertisers and users?
- 3) How much of it will advertisers and users buy? and
- 4) What is the value of these options?

In our view, Facebook will need to pursue opportunities that are readily monetizable such as online search, e-commerce, and partnerships with telecommunication companies to jump start their mobile efforts. Our work points to \$9 of incremental value (\$7 for search; \$2 for e-commerce) if Facebook were to pursue those opportunities to monetize their user base. Looked at another way, if we assume Facebook captures only 1% of its incremental market opportunities by 2016, the shares would be worth \$51 today.

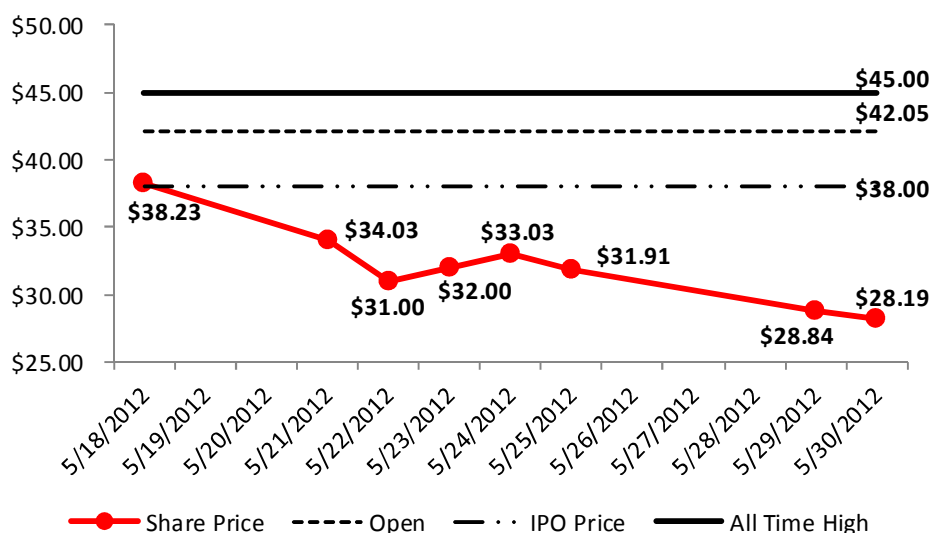
Facebook is currently valued at 24x 2012E EV/EBITDA, and 65x our 2012 Adjusted EPS estimate. Our \$40 price target for year-end 2013 is based on a 20x multiple to our 2014E Adjusted EBITDA estimate, a reasonable multiple considering our 29% long-term Adjusted EBITDA growth estimate. This is further supported by a DCF with a WACC of 11% and 7.6x implied terminal multiple on EBITDA. Our price value is based on the intrinsic value of the current revenue and profit streams and excludes the value from the future options. Risks include lock-up expirations, loss of partners, and loss of advertisers.

## Overview of the IPO

Facebook went public on May 18, 2012 at \$38 per-share, at the high end of the \$34 to \$38 range. The IPO netted \$16 billion, the highest ever for an Internet based company, with \$6.76 billion going to Facebook and the balance to selling shareholders. Facebook sold 180 million shares in the offering and selling shareholders sold 241 million shares for a combined share sale of 421 million shares. On the first day of trading the stock opened at \$42.05, 11% above the IPO price, but closed at \$38.23, up less than 1%.

Facebook's share price is down 26% from the IPO price, versus a 2% increase in the Nasdaq from May 18, and down 37% from its all-time high of \$45 reached on the first day of trading.

**Exhibit 1. Facebook's Share Price History**



Source: Thompson One; Topeka Capital Markets